The company also has the alternative of replacing 80 percent of the workers in the metals processing unit with sophisticated and expensive robotic equipment at a net annualized cost of $3 million (net of the savings in labor costs). This would result in the layoff of 48 employees. What should the company do?

Citigroup and Subprime Lending

On September 6, 2000, Citigroup, Inc., announced an agreement to acquire Associates First Capital Corporation in an exchange of shares valued at $31.1 billion. The Associates was the largest publicly traded finance company with managed assets of $100 billion and shareholders equity of $10.4 billion. The Associates had 2,750 offices with approximately 1,000 in the United States and the rest in 13 other countries.[35] The Associates also did business through thousands of independent brokers. Citigroup had managed assets of $791 billion, shareholders equity of $51 billion, and operations in 100 countries. Citigroup chairman and CEO Sanford I. Weill said, "Our consumer finance operations are very well regarded. We are excited about the prospects for the combined operations." Keith W. Hughes, chairman and CEO of the Associates, said, "We are excited to be joining forces in this effort, contributing the energy and drive that has led the Associates to twenty-five consecutive years of record earnings."[36] Citigroup planned to merge the U.S. operations of the Associates into its CitiFinancial unit, which also provided consumer finance. Hughes would be the head of CitiFinancial and join Citigroup's board of directors as vice chairman.

The acquisition of the Associates brought Sandy Weill back to his roots. In 1986 he became CEO of a Baltimore finance company, Commercial Credit Corporation, that lent to working class families. He built the company through internal growth and acquisition and later merged The Travelers Group with Citicorp to form one of the largest financial institutions in the country. As a result of the merger Commercial Credit was succeeded by CitiFinancial, which in 2000 had $18.5 billion in loans and $390 million in profits. The Associates had profits of $409 million in the second quarter of 2000 and had 480,000 home equity loans outstanding. With the acquisition CitiFinancial would become the nation's largest finance company.

A major profit source for CitiFinancial and the Associates was subprime lending—lending to people who did not meet the customary credit requirements of banks. The growth of subprime lending during the 1990s had been spectacular, with lending increasing 13-fold between 1993 and 1999. Outstanding subprime loans were estimated at $150 billion in 1998. This lending had provided access to credit to many people who would not have qualified for prime loans because of their credit history. A study by Freddie Mac, however, estimated that perhaps one-third of subprime borrowers could have qualified for prime loans, and Freddie Mac chairman Franklin Raines believed that as many as half might be able to qualify. One study found that 35 percent of the subprime borrowers were over 55, and African Americans were twice as likely to borrow in the subprime market as in the prime market.

The growth in subprime lending was also driven by aggressive marketing by the subprime lenders. The lenders relied on both mass advertising and direct marketing. One form of subprime lending was home equity loans marketed to borrowers to consolidate their bills. *BusinessWeek* commented on an example of such a loan on the CitiFinancial Web site: "'I now can afford so much more than I thought possible,' says Spencer L. of Worcester, Mass. A sample worksheet shows that Spencer can take out a $20,000 home-equity loan to consolidate his bills, pay off credit cards, and reap $310.57 in 'monthly savings.' The fine print notes that Spencer will pay that back in 120 months at a 13.49 percent interest rate. But nowhere on the Web site does it say that it would cost $36,500 to pay off starting debts of $17,000."[37]

Subprime lending had generated vocal complaints from consumer and activist groups, which referred to it as predatory lending. Many of the people who borrowed in the subprime market were lower income, minority, and elderly, and consumer advocates claimed that they often did not understand the loans and what was bundled with them. Some of these critics referred to the Associates as a "rogue company."

A second aspect of subprime lending was single-premium life insurance sold along with a loan to pay off the principal in the case of the death of the borrower. The insurance premiums for several years were typically charged up front and added to the loan principal. Moreover, the insurance often covered not only the loan principal but the insurance premiums and the interest on the loan. Frequently, the insurance did not cover the entire period of the loan. Because the premiums were packed into the loan principal, the insurance was financed at the

[35]The Associates had been owned for a decade by the Ford Motor Company, which spun off the unit in 1998.
[36]Citigroup press release, September 6, 2000.

[37]*BusinessWeek*, March 19, 2001.

high interest rates on the loans. The resulting cost of single-premium life insurance was considerably higher than the cost of term life insurance. This single-premium life insurance was criticized by community activists and government officials because many borrowers did not understand that it was included in the loan principal. The Consumer Federation of America called this "the worst insurance rip-off" in America.

As an example of a complaint involving insurance, Benny and Linda Mackey of Chocowinity, North Carolina, had fallen behind on their $519 monthly mortgage payments, and refinanced their $37,117.76 mortgage with the Associates. The Associates added a $4,231 "loan discount" to their principal and also added $4,910.08 in life insurance premiums to the loan. At a 14.99 percent interest rate the Mackeys' monthly payment rose to $592. When they missed some payments, the Associates harassed them and threatened foreclosure, according to the Mackeys. The Mackeys filed a complaint with the state of North Carolina, and the Associates lowered their payments to $370 at a 9 percent interest rate. Alan Hirsch, a deputy attorney general of North Carolina, said that single-premium credit insurance was the most egregious practice, since "many borrowers don't understand it's been included in the loan." The attorney general of North Carolina had begun an investigation of the Associates in 1999 and subsequently filed a lawsuit against the company. The investigation focused on packing insurance premiums in the loan and financing it at high rates. North Carolina also enacted an antipredatory lending law.

Both the Associates and CitiFinancial sold single-premium life insurance. The Associates issued insurance through its subsidiary, Associates Corporation of North America, which over the past 5 years had collected $1.8 billion in insurance premiums and recorded earnings of $397.5 million.[38] Fannie Mae and Freddie Mac refused to buy first mortgages with single-premium credit insurance.

One of the principal critics of subprime lenders was ACORN (Association of Community Organizations for Reform Now). ACORN was an organization with 500 neighborhood chapters in 50 cities focusing on supporting low- and moderate-income families. It filed numerous lawsuits on behalf of people whom it viewed as victims. ACORN referred to subprime lending as "legalized robbery" and listed the following among the predatory lending tactics used by subprime lenders:[39]

- Charging excessive interest rates not justified by the risk involved
- Charging and financing excessive points and fees
- Packing loans with additional products like financial credit insurance or club memberships
- Charging extended prepayment penalties that trap people in high-interest-rate loans
- Financing single-premium credit insurance
- Misrepresenting the terms and conditions of loans
- Charging unfair and excessive late fees
- Refinancings, and especially repeated refinancings, that result in no benefit to the borrower
- Balloon payments and negative amortization schedules on high-cost loans
- Targeting high-cost loans to vulnerable borrowers, including the elderly, low-income, and minority families
- Using harassing and intimidating collection techniques

In particular, ACORN had criticized CitiFinancial and the Associates for sales of single-premium life insurance, high up-front fees, and high prepayment fees. ACORN had asked the companies to stop these practices.[40]

AARP (American Association of Retired Persons) also was concerned about predatory mortgage lending because many people over 50 were using subprime borrowing. AARP was studying subprime lending and was considering a campaign against it. A campaign would involve both public education and support for stringent state legislation to curtail abuses.

Regulation of subprime lending was loose, and the relevant agencies were considering whether tighter supervision was warranted. The relevant regulators were the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

One lever of the community activists had been taken away in 1999 when Congress passed banking reform legislation. The legislation eliminated a requirement that in approving bank acquisitions the Federal Reserve Board had to solicit and consider consumer opinions on how well the banks met the requirements of the 1977 Community Reinvestment Act (CRA). That Act required banks to loan in the communities in which their offices were located. The legislation eliminated this requirement in the case of the acquisition of financial companies that did not take deposits. Since the Associates did not take deposits, Citigroup was only required to provide information to federal regulators about CRA performance. Groups such as ACORN had regularly used the CRA requirement to scrutinize the banks' lending data and extract lending pledges from the banks.

When the acquisition was announced, Representative Stephanie Tubbs Jones (D-OH) said, "Citigroup needs to know there are members of the House banking committee—particularly the Congressional Black Caucus members—who are concerned about the merger and

[38] *New York Times*, October 22, 2000.
[39] ACORN, "Predatory Lending: A Growing Problem," www.acorn.org.

[40] ACORN also launched a campaign against Household Finance for what it called abusive and predatory practices.

they need to be concerned about our concerns." A North Carolina group had shown the Black Caucus a videotape of a man who had gone to an Associates office for a loan to buy groceries and over the next 10 years had been persuaded to refinance the loan 11 times, resulting in a $50,000 mortgage at an interest rate of 19 percent.[41]

The Associates had been named in approximately 700 lawsuits and had been fined $147,000 by the state of Georgia. The Department of Justice had filed a lawsuit against the Associates alleging that one of its credit card banks had violated fair lending laws in marketing credit cards to Hispanics.[42] The Federal Trade Commission (FTC) had initiated an investigation of the Associates in 1999 for allegations of deceptive marketing practices. Since 1998 the FTC had filed 14 lawsuits involving subprime lending, including complaints against the Associates. Citigroup was surprised by the intensity of the criticisms of its acquisition of the Associates and more generally of subprime lending. The allegations of predatory lending and deception were serious, and they threatened a highly profitable business. In response to the criticisms William Street, a Citigroup attorney, said, "Citigroup is committed to improving . . . the compliance systems and operation systems and anything else they determine needs improving to meet their standards."[43]

In a letter to the Comptroller of the Currency, the Superintendent of the New York State Banking Department, and the Chairman of the Federal Deposit Insurance Corporation, the regulators that had to approve the acquisition, Sandy Weill stated, "We prize our long-standing reputation for service to customers and communities and we recognize that CitiFinancial's position as the soon-to-be largest consumer finance company in the U.S. gives it the opportunity to play an even more important and valuable role in communities in which it does business."[44] The motto on Citigroup's 1999 annual report was "Leading by Example."

SOURCE: This case was prepared from public sources by David P. Baron.

Preparation Questions

1. Are there moral concerns associated with subprime lending? Are those moral concerns based on utilitarianism, rights, or justice considerations?
2. What should CitiFinancial do about single-premium life insurance?
3. What should CitiFinancial do about the other allegations of abuse?
4. Should Citigroup support the efforts of ACORN and AARP to weed out unscrupulous practices? Should it support tighter regulatory supervision of the subprime lending market?
5. What policies should Citigroup adopt for subprime lending?

[41] *Washington Post,* September 15, 2000.
[42] *Washington Post,* September 15, 2000.
[43] *Washington Post,* September 15, 2000.
[44] Citigroup, November 7, 2000.

Consumer Awareness or Disease Mongering? GlaxoSmithKline and the Restless Legs Syndrome

"The words 'It's frustrating,' shaped to look like a pair of legs, float across the screen. A voice intones: 'It's frustrating. Just when you're ready to relax, you feel the compelling urge to move.' Eventually, the legs morph into those of a woman draped lazily across a recliner."[45] "When I saw the ad, it pretty much described me to a tee. If that doesn't do it, then I'll talk to my doctor about trying something else," said Frank Stevens of Gillette, Wyoming.[46]

The advertisement was promoting GlaxoSmithKline's (GSK) drug Requip for the treatment of restless legs syndrome (RLS), a neurological condition causing an itchy, restless sensation in the legs. Requip (ropinirole) had earlier been approved for the treatment of Parkinson's disease, and in 2005 it was approved for RLS with 2–4 milligrams doses versus 15 milligrams for Parkinson's disease.

In 2005 GSK spent $36 million to advertise Requip according to Nielsen Monitor-Plus. Sales increased by $50 million, or over 50 percent, in the United States. Worldwide, Requip was projected to have sales of over $500 million in 2006 with more than half accounted for by RLS.

GSK had begun an intensive promotional campaign for Requip prior to approval by the Food and Drug Administration. It began issuing press releases in 2003 referring to research presentations at an American Academy of Neurology conference. It then began advertising to doctors in medical journals and then turned to direct-to-consumer advertising. In 2003 it began developing consumer awareness of RLS with an advertising campaign stating a "new

[45] *Washington Post,* May 30, 2006.
[46] *Washington Post,* May 30, 2006.